BANK OF ISRAEL
Office of the Spokesperson and Economic Information

June 2009

Report to the public of the Bank of Israel's discussions prior to setting the interest rate for June 2009

The discussions took place on 24 and 25 May 2009

General

Before the Governor makes the monthly interest rate decision, discussions are held at two levels—the first in a broad forum, and the second in a narrower one.

In the broad-forum discussion, the relevant background economic conditions are presented, including real, monetary and financial developments in Israel's economy and developments in the global economy. Participants in this discussion include the Governor, the Deputy Governor, the directors of the Research and Market Operations Departments of the Bank and economists from various departments who prepare and present the material for discussion. The data, estimates and assessments in these minutes are those that were available at the time of the discussions.

In the narrow forum, the directors of the Research and Market Operations Departments and two other participating members of management present their recommendations regarding the interest rate and, following a discussion, the Governor makes his decision.

A. THE BROAD-FORUM DISCUSSION—THE STATE OF THE ECONOMY

1. Developments on the real side

General assessment

In the month since the previous interest rate discussions, the signs of moderation in the negative trend in economic activity firmed. The Bank of Israel expects renewed economic growth in the Israeli economy towards the end of the year.

The National Accounts

According to the preliminary estimates of the Central Bureau of Statistics (CBS), Israel's GDP contracted at an annual rate of 3.6 percent in the first quarter of 2009. The decline is in line with the Bank of Israel's forecasts. The drop in GDP resulted from a 46.3 percent fall in exports, a 4.3 percent decline in private consumption, and a 37.6 percent reduction in nonresidential investment. Imports also slumped, by 62.7 percent (all rates in this section are annual rates, compared with the previous quarter).

The composite state-of-the-economy index

The composite state-of-the-economy index for April declined by 0.3 percent, following the declines (month-on-month) of 0.7 percent in March, 1.3 percent in February, and 1.5 percent in January. These reflect the contraction of economic activity in the last few months, with the rate of decline moderating.

The index of manufacturing production (seasonally adjusted) fell in March by 2.1 percent, after holding steady in February. The index of trade and services revenue rose sharply in March, by about 4 percent, after declining by 0.6 percent in February (month-on-month changes, seasonally adjusted).

The labor market

The nominal wage per employee post in the business sector increased by 0.1 percent in February compared with its January level. The average nominal wage fell by 3.9 percent, annual rate, in the three months December–February compared with the average in the previous three months (seasonally adjusted).

The number of employee posts (seasonally adjusted) was unchanged in February. National Insurance Institute data indicate that the level of employment declined by 3.7 percent in the three months December–February compared with the level in the previous three months.

The unemployment rate reached 6.9 percent in February (based on trend data), similar to the January level.

Foreign trade

Goods exports (excluding diamonds) shrank by 1.9 percent in April from their March level (all changes in this section are in dollar terms, seasonally adjusted). In the three months February–April they fell by 41 percent compared with the level in the previous three months.

Goods imports (excluding ships, aircraft and diamonds) declined by 1.8 percent from March to April, In the three months February–April they fell by 49.5 percent (annual rate) compared with the level in the previous three months. The reduction was partly due to the fall in energy prices in this period, but mainly due to the drop in demand.

2. Budget data

After adjusting for the effects of changes in tax rates and non-recurring revenues, tax revenues dropped by about 15 percent in real terms in January–April compared with January–April 2008, a reflection of the economic slowdown. That said, April was the second month in succession in which the rate of decline in tax revenues slowed, in particular that of indirect taxes.

On 13 May the government approved the budget for 2009 and 2010. In light of the economic recession and the sharp drop in tax revenues, it was decided to raise the deficit ceiling specified by law from 1 percent of GDP to 6 percent in 2009, and 5.5 percent in 2010. Based on existing legislation, these deficits approximately reflect the effects of the automatic stabilizers.

The government decided that the maximum rate of increase in government expenditure (the ceiling) would be about 3 percent in 2009 and 1.7 percent in 2010, and that it would return to the original expenditure path in 2011; to achieve the latter requires setting the ceiling for 2011 at an increase of less than 1 percent.

3. Developments on the nominal side

Inflation

The Consumer Price Index (CPI) rose by 1 percent in April, in line with forecasters' expectations. Since the beginning of 2009 the CPI has risen by 0.9 percent, and in the last twelve months by 3.1 percent, slightly above the upper limit of the target range.

Expectations and forecasts of inflation and of the Bank of Israel interest rate

One-year-forward inflation expectations derived from the capital market ("break-even inflation") increased in May, reaching about 2.4 percent (on 21 May); average expectations from 1–21 May were 1.9 percent, compared with an average of 0.9 percent in April.

Most of the increase in inflation expectations and forecasts in the month between the previous and the current interest rate discussions resulted from the government decision to increase the rate of VAT and taxes on cigarettes and fuel. These tax increases are likely to be reflected in one-off price increases in the next few months.

On average the Israeli forecasters expect inflation in the next twelve months to be about 2.2 percent, compared with expectations of 1.2 percent at the time of the previous discussions. They expect, on average, a cumulative increase of 1.1 percent in the CPI from May to July 2009.

With regard to the interest rate, the Israeli forecasters expect on average that the Bank of Israel rate will remain unchanged for June, and that twelve months hence it will be about 1.4 percent.

An analysis of the slope of the *makam* yield curve shows that capital market traders expect the interest rate to be increased in the second half of the year, and to be at a level of about 2.2 percent a year hence.

The makam and bond markets

The yield on 5-year CPI-indexed government bonds increased from 1 May to 21 May to an average of about 1.6 percent, compared with an average of about 1.2 percent in April. In the same period the yield on unindexed 5-year government bonds increased to an average of 3.9 percent, from 3.5 percent in April. The yield on one-year *makam* increased to an average of about 1.1 percent, from about 0.9 percent in April.

The interest rate differential and the yield gap between Israel and abroad

Prior to the current interest rate decision, the Bank of Israel interest rate was 0.25–0.5 percentage points higher than the US federal funds rate, and 0.5 percentage points lower than the ECB rate.

The gap between the unindexed 10-year shekel government bond yield and the 10-year US government bond yield remained quite steady at 193 basis points on 21 May compared with 191 basis points on 27 April.

The expected real interest rate

The Bank of Israel interest rate *minus* twelve-months-forward inflation expectations derived from the capital market fell by about 0.2 percentage points in May from its April level, and reached an average of a *negative* 0.5 percent.

The monetary aggregates

In the twelve months to May 2009 the M1 monetary aggregate (cash held by the public and demand deposits) grew by 58.5 percent, and the M2 aggregate (M1 plus unindexed deposits of up to one year) by 19.5 percent. The rapid increase in M1 was partly due to the public's switching from deposits to current accounts in light of the low level of interest on the deposits.

The econometric models[1]

Various scenarios were examined using the Bank of Israel's econometric models, under the assumptions that GDP will contract by 1.5 percent in 2009, that the low interest rates around the world will start to increase in 2010, that prices of imported inputs will increase from the second quarter of 2009, and that world trade will contract by 9 percent in 2009.

In the basic quarterly DSGE (dynamic stochastic general equilibrium) model, which places great weight on expectations and which uses the Bank of Israel reaction function based on the smoothing of the interest rate path, in the scenario in which the exchange rate in the second half of 2009 is between NIS 4.16 and NIS 4.19 to the dollar—the Bank of Israel interest rate declines gradually to a level of zero percent in the first quarter of 2010, and in 2009 as a whole inflation is 1.5 percent.

4. The foreign currency market and the share market

The foreign-currency market

During the month between the previous and the current interest rate discussions, the shekel strengthened by about 6.5 percent against the dollar, from NIS 4.23 to the dollar (on 27 April) to NIS 3.96 (on 22 May). In the same period the shekel strengthened by about 0.7 percent against the euro, from NIS 5.56 to NIS 5.52 to the euro.

The nominal effective exchange rate of the shekel, calculated as the average shekel exchange rate against 24 currencies (representing 33 countries) weighted

[1] The Bank of Israel uses econometric models to test various scenarios. Due to their nature, including the fact that their results naturally depend on certain assumptions about relevant variables, the scenarios should be viewed as one input among several in the discussions on the interest rate. In the abnormal conditions prevailing in the financial markets since the outbreak of the global financial crisis, and bearing in mind that the models do not direct reflect such events, the weight that can be attached to the forecasts derived from the models is reduced.

according to the volume of Israel's trade with those countries, showed a shekel appreciation of about 2.7 percent in the period from 27 April to 24 May.[2]

The share market

The Tel Aviv 25 share price index increased by 9.1 percent between 27 April and 21 May, while the Dow Jones index climbed by about 3.3 percent.

5. Israel’s financial risk, the sovereign risk premium

Israel’s risk premium, as measured by the five-year CDS spread, decreased in the month to the current discussions from 1.8 percent to 1.5 percent. The risk premium of most emerging market countries also declined in this period.

6. Global economic developments (see Appendix for further details)

Data on global growth indicate a slower rate of deterioration in the global economy and some improvement in the global financial markets, with share price indices and commodity prices showing substantial increases. Nevertheless, the economic environment is still weak, and the basic economic data indicate a deep recession, with a sharp decline in world trade. It seems that the crisis has entered a new phase, and that the panic that followed the collapse of Lehman Brothers and concern over the possible collapse of financial systems are giving way to assessments of the timing of the recovery from the recession. Expansionary monetary policies continued with significant fiscal expansions in most countries, supporting the recovery of the global economy.

In the US the investment houses expect, on average, that the Fed interest rate will stay at its current level (of zero to 0.25 percent) till the end of 2009. The ECB cut the interest rate in May by 25 basis points to 1.0 percent.

In light of the fact that in some countries the headline interest rate is close to zero, central banks are turning to additional policy instruments to pursue an expansionary policy.

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B. THE NARROW-FORUM DISCUSSION—THE INTEREST RATE DECISION FOR JUNE 2009

In the narrow-forum discussion, four members of management make recommendations to the Governor regarding the appropriate rate of interest for the economy. In the discussion of the interest rate for June, all four recommended that the Governor leave the interest rate unchanged at its current level, and that he continue to pursue the expansionary policy by operating the additional tools that the Bank has been employing in the last few months.

[2] The weight of the dollar in the effective exchange rate is about 24 percent, and that of the euro, about 35 percent.

The participants in the discussion stated that a decision not to change the interest rate this month would be consistent with the achievement of the inflation target. The Israeli forecasters predict, on average, that at the end of 2009 inflation measured over the previous twelve months will be at the desired level, around the midpoint of the target range. One-year-ahead inflation expectations derived from the capital market are also close to the midpoint of the range.

In the discussion the point was made that the Bank of Israel is taking steps to support economic activity and increase liquidity in the financial markets, and is operating a variety of tools in order to achieve its objectives:

- The Bank is keeping the rate of interest at a low level;
- It is continuing to buy foreign currency at a rate of $100 million a day, in the context of its planned increase in the foreign exchange reserves, and in order to support economic activity;
- It is also continuing to buy about NIS 200 million a day of medium- and long-term government bonds on the secondary market. These purchases act directly towards lowering longer term interest rates, and thus serve to boost economic activity.

At the end of the discussion, the Governor decided to leave the interest rate unchanged for June, at 0.5 percent, and to persist with the other policy tools, with the intention of continuing to encourage economic activity.

The Bank stressed the following points in its announcement of the interest rate decision for May:

- Inflation in Israel is expected to be in line with the target—last month inflation forecasts and expectations increased to around the midpoint of the target range, so that from the aspect of achieving the target, there is no need for a change in the interest rate.

- The low rate of interest combined with the other instruments that the Bank is using helps to encourage economic activity. The data point to a moderation in the rate of decline in activity. It is expected that economic growth will resume towards the end of 2009.

The Bank of Israel will continue to act to achieve the price stability target, and closely monitor Israeli and worldwide economic developments, with the intention of encouraging employment and growth and supporting financial stability.

The decision was made and published on 25 May 2009.

Those participating in the narrow-forum discussion:
Prof. Stanley Fischer, Governor of the Bank of Israel
Prof. Zvi Eckstein, Deputy Governor of the Bank of Israel
Dr. Karnit Flug, Director of the Research Department
Dr. Edward Offenbacher, Member of Management and Head of the Monetary and Finance Division, Research Department

Mr. Barry Topf, Director of the Market Operations Department
Dr Ohad Bar-Efrat, Advisor to the Governor and Head of Information and International Affairs Division
Mr. Eddy Azoulay, Chief of Staff to the Governor
Dr. Yossi Saadon, Bank of Israel Spokesperson

Appendix: Major Global Economic Developments

US

The US economy contracted by 6.1 percent in the first quarter of 2009 (annual rate, compared with the previous quarter), following its 6.3 percent contraction in the last quarter of 2008. Companies' investment remains very weak. Recently published company surveys were slightly more positive, but indicated that new orders were down and investment plans are being held back, suggesting continued weakness in the near future. That said, the decline in inventories may well lead to renewed growth towards the end of the year. The labor market is still very weak, partly due to the bleak situation in the car industry. Firms are still not taking on new workers. The persistent weakness in this market is expected to impact on households' income, and adversely affect consumption and the economic recovery. Nonetheless, some hopeful signs are evident, including a fall in the rate of job losses in April.

Europe

The economy of the euro area contracted at an annual rate of 2.5 percent in the first quarter of 2009 compared with the last quarter of 2008, further to its 1.6 percent decline in the previous quarter. In Germany GDP fell by 3.8 percent in 2009:Q1, and in Italy, by 2.4 percent. The UK economy contracted at an annual rate of 1.9 percent.

On 7 May the ECB announced a reduction of the interest rate by 25 basis points, to 1 percent, and stated that it would operate a program aimed at easing credit and increasing liquidity. These decisions resulted from the ECB's assessment that inflation would remain in check due to the recession. There are initial indications that economic activity in the euro area is stabilizing at a very low level, after the first quarter which turned out weaker than had been anticipated.

Japan

Japan's GDP dropped at an annual rate of 15.2 percent in the first quarter of 2009, following its 14.4 contraction in the last quarter of 2008 (quarter on quarter). This occurred against the background of a slump in exports, a sharp reduction in private consumption, a decline in investments, and a large drop in inventories. However, last month there were signs of a recovery, including in exports and manufacturing production. Indications of stabilization in the global markets and the package of fiscal measures totaling ¥ 15.4 trillion introduced to deal with the situation serve to boost residents' confidence. The increases in the share markets and positive company profit forecasts contribute to the atmosphere of cautious optimism.

The emerging markets

Some recovery is evident in the emerging market countries, and capital outflow from them slowed recently, against the background of investors' risk aversion. These trends strengthened, particularly after the meeting of the G20 in London, when it was decided to transfer $1.1 trillion to the IMF. Some of the emerging markets, and in particular China, are showing signs of recovery driven by domestic factors which augment the positive trend. The latest economic data show a recovery of activity in China, as a result of the implementation of the $585 billion program to boost the economy. In April there was a sharp increase in credit given to companies and households.